Senate Committee on Economic Development and Technology and
House Commiteee on Economic Revitalization, Business, and Military Affairs
Joint Info Briefing on Act 221 • Tuesday, January 20, 2009

Legislators in Attendance:

EDT	*EBM*
Chair/Senator Carol Fukunaga	Chair/Representative Angus McKelvey
Vice-chair/Senator Rosalyn Baker	Vice-chair/Representative Isaac Choy
Senator David Ige	Representative Clift Tsuji
Senator Sam Slom	Representative Gene Ward

AGENDA

1. How did Act 221 Arise? — *Ray Kamikawa, Chun Kerr Dodd Beaman & Wong, Director/Department of Taxation (1993-2000).*

Mr. Kamikawa provided background on the history and external circumstances that led to adoption of ACT 221 (SLH 2001). Earlier, Hawaii's Legislature adopted two technology tax incentives (ACT 178, SLH 1999 and ACT 297, SLH 2000), but found that their adoption did not generate interest in Hawaii's tech businesses by national/international investment firms.

With ACT 221, the Legislature adopted a market-driven approach, where tech companies would have to stand on their own, and attract their own investors. Hawaii's legislation moved away from venture capital model of Silicon Valley, because many in the tech community realized that, under a Silicon Valley model, local tech companies that were successful in attracting outside capital would eventually be forced to relocate out-of-state (to be closer to their venture investors).

The Legislature patterned ACT 221 on the low-income housing credit, which allows investors 100% return on its investments (federal/state piggy-back credit) over 10 years. However, the problem with low- income tax credits was that they are allocated by a federal or state agency. A local housing board would determine who would receive credits, and investors would never know what went into those decisions.

ACT 221 allows credits that cannot be used by non-Hawaii investors (e.g., who have no state tax liability) to be allocated to investors who could use them (e.g., 2:1 multiples). The State Legislature needs to consider both direct and indirect effects of ACT 221 in evaluating its benefits.

2. Reports on Act 221 (September/December 2008) — *Kurt Kawafuchi, Director/Department of Taxation, 2003-present (refer to powerpoint presentation).*

- **Question: Senator Fukunaga** asked Mr. Kawafuchi whether individual investors who can claim the tech credits are confined to a certain type of investor.

- **Response: Director Kawafuchi** said yes, those most likely to use ACT 221 credits are the accredited type of investors. This class of investor is exempt from federal registration (e.g., "high net-worth individuals) due to his/her sophisticated experience in high-risk market investments. Wealthy investors can invest money to create jobs and companies without worrying about whether the companies might fail, thereby losing all their investment. He would not recommend that moderate-income people to invest in tech industry, due to its volatility.

3. Experiences of Act 221 Businesses — *Jeff Au, PacifiCap Group (refer to powerpoint presentation); and David Watumull, Cardax Pharmaceuticals, Inc. (refer to powerpoint presentation)*
Mr. Au explained that, in ACT 221 investments, the market - not some federal agency - dictates how investors will invest their money. "Credit Multiples" actually mean "credit allocation". Credits are only re-allocated among investors, there are no “multiples” of credits being used.

Mr. Au also clarified several points covered during the presentation on Department of Taxation's September 2008 and December 2008 reports. He said that financing risk is the most challenging aspect to investors. The September 2008 report identified $295.6 million as the actual gross cost to the state of ACT 221 credits being claimed. Mr. Au pointed out that contractor jobs, otherwise characterized by Department of Taxation as seasonal/temporary, should not mean that these jobs are not legitimate kinds of jobs (e.g., in evaluating construction benefits, all jobs created are treated as legitimate jobs, whether they're seasonal or temporary or permanent ones).

4. Questions from EDT and EBM Committee Members

- **Question: Representative Ward** asked if the legislature should keep it or dump the credit. He also asked Director Kawafuchi why his cost benefit model doesn’t fit that of ACT 221 proponents David Watumull or Jeff Au?

- **Response: Director Kawafuchi** responded that his department is trying to work with the industry. DOTAX has used a static model, in which his research staff looks at the cost of a tax credit, not the dynamic impacts or benefits from a credit. DOTAX uses the same methodology used by former directors of DOTAX.

  Response: Jeff Au responded that the DOTAX report is good, the empirical data is fine, he has nothing against the report. The problem comes with the *interpretation* of data. The DOTAX report indicates job acquisition cost is $535,000 dollars per job, whereas an individual job's salary is estimated at $73,000 dollars a year. Could the job acquisition cost be salaries for multiple years? Problem is not how data is collected, but how it is being reported/interpreted. DOTAX has met with industry, which been giving feedback to the department. QHTB’s are not spending 100% of their investment dollars raised on salaries. These benefits are just a tip of the iceberg.

  Response: David Watumull responded that 177 companies spent $1.4 billion in Hawaii. He views ACT 221 as generating more than double the economic benefit or possibly triple economic benefit as its cost.

- **Question: Representative McKelvey** asked Director Kawafuchi if his department has looked at total scenarios (of costs and benefits).

- **Response: Director Kawafuchi** responded that the DOTAX reports for September and December 2008 doesn’t include new investments in 2008 and forward. He pointed out that his department is not seeking repeal of ACT221 credits, but seeks tightening of credits because his staff sees cases where they have to say “no” to certain companies who are overreaching. He wants to minimize any adverse effects of credit cuts.

  Response: Jeff Au responded by saying that companies shouldn’t overreach, but if they are the exception, rather than the rule, then we need to keep things in context and look at the overall benefits.

  Response: Director Kawafuchi stated that yes, the overreaching is the exception, rather than the rule.

- **Question: Senator Baker** asked whether DOTAX would be providing the legislature with an objective/comprehensive report of data or not, based upon the information gained at this briefing. Senator Baker and Representative McKelvey both asked for revisions to the December 2008 report (e.g., reflecting accurate costs and accurate benefits) based on the questions raised at the briefing.

- **Question: Representative Ward** asked Director Kawafuchi how he intends to tweak ACT 221.

- **Response: Director Kawafuchi** replied that DOTAX modifications to ACT 221 will generate savings of $65 million over the two-year biennium.

  Response: Jeff Au suggested that the department needs to look at data and to quantify what the problems are before the Legislature can come up with rational solutions.

  Response: David Watumull asked whether the idea of reducing ACT 221 is something that the legislature should be considering. He said, "maybe we should be looking at how we can expand the economy or grow it." An X amount of savings from ACT 221 changes is something he challenges.

  Response: Jeff Au pointed out that the problem with changes to ACT 221 is that the law was intended to encourage investment - private investment. All the money that comes in through private investment is not reflected in the general fund 'costs' of the credit.

  Response: Shan Steinmark introduced himself as a private investor from the audience. He said that, without ACT 221 tech credits, he would roll-over his real estate investments so he faces no exposure in terms of additional tax liability. He and his investor colleagues invest in companies because of the potential for their growth, as well as the potential value they have for the state. The picture being painted by the media is false. He and his wife have accrued the money they invested in ACT 221 companies over a period of over thirty-five years (and not because they're wealthy individuals).